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Global Hotspots in the Real Estate Business

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Emerging real estate markets in India and China, along with recovering property industries in Germany and Japan, are among the top destinations for global real estate investors, according to panelists at the Samuel Zell and Robert Lurie Real Estate Center's fall meeting.

During a session titled, "Global Hot Spots -- How to Think about Hot Foreign Markets," Wharton real estate professor Peter Linneman (http://www.wharton.upenn.edu/faculty/linneman.html) called on each panelist to describe the markets they find most intriguing. "How much is hype? How much is reality?" he asked.

Stuart Rothenberg, managing director at Goldman Sachs and head of its real estate principal investment area, said his company is most interested in Germany. The country has property available that generates strong yields, a recovering economy and efficient financing. In addition, German banks are liquidating large portfolios of non-performing loans, creating opportunities to buy residential property with yields of 4.75% to 5.25% and commercial property yielding just above 5%.

Rothenberg is optimistic about the German market because new supply has been limited by a sluggish economy, until now. Recently, multinational corporations have expressed interest in establishing German headquarters, which will drive down vacancy rates. Governments, he added, are taking steps to speed the pace of privatization. Goldman Sachs' first German acquisition was a state-owned residential portfolio in Berlin. "The only bad news about Germany is you are competing against a lot of German funds," he said.

China is the top pick for Keith Barket, senior managing director at Angelo, Gordon, an alternative money management firm with $10 billion under investment. Barket said his firm does not take on large portfolios, but makes single asset acquisitions in a targeted, "rifle-shot" approach. The firm began to look beyond U.S. holdings more than six years ago and was drawn to China by its rapid economic growth -- projected to hit a continued 9% a year.

Angelo, Gordon uses a partnership model for its real estate investments, which Barket said works well in the United States but has been harder to duplicate in China where there are fewer equity partners available. However, he added, this is not a huge problem because he often runs into similar differences in managing local partnerships within the United States. Partners in New York, for example, are radically different than those in the Middle West, he said.

Angelo, Gordon searches for partners in China, much the way it does in the United States -- getting to know the handful of real estate experts in any one location. In Shanghai, for example, there are less than a dozen brokers, lenders and developers to know. "The real estate world is a small world," Barket said.

Michael Pralle, president and chief executive officer of GE Real Estate, with a $48 billion portfolio, said his firm is most interested in Japan. Yields are good and interest rates remain extremely low. Meanwhile, the economy is finally in recovery, but real estate prices remain near 25-year lows. Pralle said GE did its first transaction in India only a year ago. "Other people were in India earlier. We are pretty cautious."

He said GE usually enters a new market with a local partner that has a specialty in the property type GE wants to acquire. For example, GE has a multifamily partner in France and has decided to focus on partners with IT parks and residential projects in India.

The firm's parent company helps forge relationships with desirable partners in emerging markets where GE is already doing business, he added. "We have a modest edge because of our parent company, which has big investments in India and China. When we come in to do real estate, we have some confidence we will be treated relatively fairly."

Opportunities in India

Linneman described panelist Surendra Hiranandani, managing director and founder of the Hiranandani Group in Mumbai, as extremely popular these days with the hordes of real estate investors trekking to India to investigate its hot property market. "There's an image that, in India, the streets are paved with gold. What's the reality?" Linneman asked.

According to Hiranandani, the Indian economy only began to open up in 1991 compared to China, where free-market reforms began to take hold in 1979. The effects of those changes are just now beginning to become evident in India. He also noted that the capital coming into India is generating greater transparency in business. "When capital is scarce, people find nefarious ways of raising it. The availability of capital automatically makes it more transparent."

Meanwhile, Hiranandani said, a new generation in India is open to free-market reforms. He pointed out that Bill Gates displaced Mahatma Gandhi as the most respected person among Indians in a recent poll. In addition, India is a young country, with an average age of just 24 and vast potential to grow. "There is a huge supply gap. It's definitely an underexploited market." He said the best opportunities are in residential and hospitality development. Large Singapore-based firms have been building office developments, which means that sector may be overbuilt.

Construction costs are low in India, making it easy to generate new value. Hiranandani also pointed out that developers have an opportunity to lead residential buyers to trade up to better homes. "People have the money. They don't know what it is to upgrade -- you have to show it to them. You're going to see a lot of activity in housing."

According to Rothenberg, real estate investors outside India worry about going into the market. "There's so much excitement about India, but people are worried about being a sucker -- the foreigners who don't know what they don't know." To get around the problem, he said, Goldman Sachs tries to focus on assets in a portfolio of non-performing loans that may be strong properties with better management. The firm sticks to existing assets in a new market and will only consider new development once it has a good handle on the potential upside and puts its own staff on the ground.

There are attractive deals in China, he adds, but they take a lot of time and energy to complete. His firm has only bought a few buildings in China's major cities. "And that's with a lot of trying over the last five years."

Hiranandani points to a shortage of properties to buy in India, but that's only because there has been so little development for decades. He said foreign developers should not be afraid of becoming suckers if they are willing to be fair to their Indian partners when structuring a deal. "You will probably have fewer problems with the government than I would as a local," he added. "The government is scared of institutions and will [get involved] more with private individuals."

He suggested that multinationals may have trouble working in India because they are large and bureaucratic, slow to make decisions and unwilling to put the effort into smaller transactions. Meanwhile, locals want to have a personal relationship with their foreign partner, particularly when dealing with private equity investors that do not have the transparency of a publicly-traded firm.

Hiranandani went on to say that there is little chauvinism or anti-American feeling in India and that the government is open to foreign capital. Communication is easy because English is spoken as a first language in most regions.

Growing Urban Populations

Foreign real estate companies must be pragmatic about the investment timeframe in India and China, suggested Pralle. While the markets are growing fast and will be important in the long term, they will yield relatively small returns over the next three to five years. "You work months and month to get these deals closed because they are more complicated. They are potentially more volatile and the government can change on a dime."

There are some existing assets worth buying in China, but most of the opportunity is in new development, Barket added. Millions of people continue to migrate from rural areas to urban centers where they need housing and other types of development. There is a huge need for equity capital. His firm is developing residential real estate at profit margins of 20% to 40% compared to 15% in the United States.

Land prices, Hiranandani notes, are rising in India but not enough to cut deeply into profitability. He, too, said millions of migrants are flowing into Indian cities and are willing to pay more than locals think. "In the last three years, whatever I thought was expensive turned out to be cheap," he said. Migrants moving into a new area are not aware of what prices were paid in the past. "So many migrants are coming in and so much is happening. People value the prime locations. They want to be a part of the action. They want to be part of the big story."

Linneman asked about the South Korean government's prosecution of the head of a U.S. private equity group, Lone Star Funds, for stock manipulation. Rothenberg said his firm passed on a South Korean portfolio because it was concerned about the government. "The feeling on the government was that it changes its mind whenever it wants. It's all about money. If you were making too much money, the government wanted it." A tax structure for a project could be agreed upon, but suddenly opened up for new audits. "They use audits to say, 'Pay up' and people like Goldman Sachs pay up because our reputation is more important to us and we don't want negative press. Lone Star said 'No.' When they didn't pay up, the Korean government saw them making too much money -- this is my view -- and it went after them because it wanted a piece."

Pralle has not seen too much of that problem in real estate, but his parent company has had similar problems with power plants in India. "If you're involved in a highly visible project and are making profits that seem extraordinary, the government gets irritated and they change the rules midstream."

Linneman asked the panelists what concerns them most about the investments they are making in today's hot spots. Barket said he worries about training his relatively inexperienced team in China and making sure it aligns itself with good local partners. He is also concerned about the stability of China's government. "In the longer run the risk I see in China is a dramatic change from what they are doing today. If they move to a democracy too quickly, that actually would be a problem, which is a little counterintuitive."

Rothenberg is confident Goldman Sachs has made the right investments in Germany; now he is concerned about operations. "We worry that what could go wrong is not a bad investment or a problem in the economy, but operationally having a malfunction -- people stealing or hiring the wrong people -- that will mess us up."

Linneman asked about capitalization rates, or the ratio of operating income to the price of a property. He said he was surprised to learn the rates were not dramatically higher in new markets compared to the United States, which would seem to be considerably less risky. The panelists said a shopping center in the United States might have a cap rate of 5%. In Turkey, it would be 6.5%, in India 8% to 12% and in China 10% to 12%. "If you believe the investment community," said Pralle. "There's very little risk in the world today."

Linneman stressed that the rise of global real estate hot spots is important to investors who may never venture outside the United States. "If you understand what is, or is not, happening in these markets, you understand the alternatives for capital that are increasingly global," he said, "and you can see how you look in comparison."

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